

In a much-awaited decision, the Supreme Court finally resolved the longstanding split among the circuit courts regarding the applicability of the settlement payment defense under 546(e) of the Bankruptcy Code (*the Settlement Payment Defense*). The *Merit Management* Courts focus on 546(e)'s scope should ease the minds of those who worried the Supreme Court would limit the Bankruptcy Code's definition of a financial institution.²¹

THE SETTLEMENT PAYMENT DEFENSE The Settlement Payment Defense shields covered entities from constructive fraudulent conveyance actions by precluding a trustee from recovering a settlement payment or transfer made by or to (or for the benefit of) these entities, including financial institutions.²⁵ Many defendant-transferees raise the Settlement Payment Defense to protect their received settlement payments.²⁰

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2. PRE-MERIT MANAGEMENT CIRCUIT SPLIT

Prior to the *Merit Management* decision, circuit courts had two views on the reach of the Settlement Payment Defense. One view (*the Plurality View*), subscribed to by five circuit courts, allowed the existence of a financial institution in the chain of transfers to insulate subsequent transferees from liability. While the defendant, typically the transactions ultimate transferee, is not a covered entity, the financial institution that makes the final payment to said transferee usually is. Thus, the theory goes that if one of the component parts to the transaction

is a covered entity, the whole transaction is protected by the Settlement Payment Defense. The Seventh Circuit proposed a different view (*the Seventh Circuit View*), which looked at the transaction as a whole and focused on the ultimate transferee. Namely, the Seventh Circuit held that the Settlement Payment Defense did not apply when the only covered entity is the financial institution that served as a mere conduit for the distribution of payment to the transferee. In *Merit Management*, one side argued in favor of the Plurality View, and the other asserted that the Seventh Circuit View applies.

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3. BRIEF FACTS IN MERIT MANAGEMENT

The *Merit Management* case involved a chapter 11 trustee (the Trustee) that identified what it considered to be a constructive fraudulent transfer from the Debtor to a transferee (the Transferee). The Trustee alleged that the Debtor purchased stock from the Transferee at a price that did not provide fair value.³ Therefore, the Trustee filed suit to recover (avoid) the allegedly dubious pre-petition payments. The Transferee filed a motion on the pleadings, whereby it argued that the Settlement Payment Defense barred the Trustee from recovery pursuant to the Plurality View. Specifically, the Transferee argued that the Settlement Payment Defense insulated the relevant transaction from scrutiny, because the final payment to the Transferee was not made by the Debtor, but rather by a protected intermediary: a financial institution that served as a conduit for the transfer of payment. The Trustee countered with the Seventh Circuit View: the Settlement Payment Defense cannot be used to insulate transfers that were made through a financial institution but did not involve said financial institution as a direct party. The Supreme Court agreed with the Trustee, but on broader grounds.

4. THE MERIT MANAGEMENT

HOLDINGThe *Merit Management* Court did not limit the definition of a financial institution in any way. Instead, it simply held that when considering the Settlement Payment Defense, courts are to concentrate on the overarching transaction from initial transferor to end transferee, and not on the component parts. Focusing its discussion on this general holding, the *Merit Management* Court clarified that using a financial institution as a mere conduit for the distribution of funds does not shield a transaction from avoidance actions. Essentially, courts should look to the transfer that the trustee seeks to avoid (i.e., A ? D) to determine whether the Settlement Payment Defense insulates said transfer, and should not look to the component parts of the overarching transfer (i.e., A ? B ? C ? D).⁴ The Supreme Court did not discuss whether the Debtor or the Transferee qualified as a financial institution. Thus, despite *Merit Managements* holding, defendants can still avail themselves of the Settlement Payment Defense if they claim financial institution status as part of their defense.**5. POST-MERIT MANAGEMENT**

IMPLICATIONS While the decision will deprive some avoidance defendants of the ability to use the Settlement Payment Defense, said defense still applies when the financial institution asserting the Settlement Payment Defense is the conduit-banks customer. The *Merit Management* ruling did not limit the Bankruptcy Codes definition of a financial institution. As previously stated, the Settlement Payment Defense precludes a trustee from avoiding a settlement payment or transfer made by or to (or for the benefit of) financial institutions. The Bankruptcy Codes definition of financial institutions includes the customer of certain banks or commercial entities when a bank or commercial entity acts as an agent or custodian for the customer in connection with a securities contract.⁵ Hypothetically speaking, a transferee that is also a customer of a bank or commercial entity serving as an intermediary to a transaction could use the Settlement Payment

Defense to insulate itself from an avoidance action, given that the Bankruptcy Code also defines said customer as a protected financial institution. At the *Merit Management* oral argument, Justice Stephen Breyer suggested that this might be a valid justification for transferees to continue using the Settlement Payment Defense.⁶ However, the Court chose to not discuss the Bankruptcy Codes definition of a financial institution, as the Transferee conceded the aforementioned point in the lower courts. Thus, it still remains true that a financial institution may avail itself of the Settlement Payment Defense if it is one of the transacting parties, as opposed to an intermediary. Given this development, the main takeaway for securities market participants is that they must demand a detailed transfer structure that gives them financial institution status in order to curtail avoidance liability. Many circuit courts are mindful of the importance of financial market stability and certainty, and the detrimental effects that would result from subjecting all securities transactions to avoidance actions. By insisting on a transfer structure whereby transferees fit within the Bankruptcy Codes definition of a financial institution, market participants will safeguard their securities transactions from avoidance risk.⁶

CONCLUSION Focusing its attention on *Merit Managements* specific facts, the Supreme Courts ruling appears to leave in place protections for certain shareholders receiving settlement payments under securities contracts. Going forward, market participants that seek certainty and finality in their transactions will be wise to ensure that they qualify for financial institution status prior to entering into a securities transaction. The Supreme Court agreed with the Trustee, but on broader grounds.¹ *Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, No. 16-784, 2018 WL 1054879 (U.S. Feb. 27, 2018).² 11 U.S.C. 101(22).

³ The Bankruptcy Code allows a trustee to seek the avoidance of fraudulent transfers. 11 U.S.C. 548(a).

⁴ *Merit Mgmt. Grp.*, 2018 WL 1054879, at *3, 12.

5 11 U.S.C. 101(22).

6 See Transcript of Oral Argument at 13-20,
Merit Mgmt. Grp., LP v. FTI Consulting, Inc.,
No. 16-784, 2018 WL 1054879 (U.S. Feb. 27,
2018) (available [here](#)).